

**LEGISLATIVE SERVICES AGENCY  
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**FISCAL IMPACT STATEMENT**

**LS 6287**

**BILL NUMBER:** SB 388

**NOTE PREPARED:** May 2, 2011

**BILL AMENDED:** Apr 29, 2011

**SUBJECT:** Swap Agreements.

**FIRST AUTHOR:** Sen. Waltz

**FIRST SPONSOR:** Rep. Speedy

**BILL STATUS:** Enrolled

**FUNDS AFFECTED:** X GENERAL  
X DEDICATED  
FEDERAL

**IMPACT:** State & Local

**Summary of Legislation:** The bill defines "issuing body", for purposes of restrictions on swap agreements, to include the state of Indiana and its agencies, commissions, and authorities, the Indiana Bond Bank, a political subdivision, county, school corporation, hospital association, municipal corporation, or special taxing district, a local public improvement bond bank, and any entity that issues bonds payable by any of these entities. The bill provides that swap agreements are covered by the restrictions only if any part of the payments owed by an issuing body is payable from tax revenues or special assessments. The bill provides that the law places restrictions on the use of swap agreements and does not authorize entering into swap agreements for any entity not already authorized under another law. It also provides that a swap agreement may be used only in connection with the financing activities of an issuing body and may not be used as an investment by an issuing body.

The bill provides that a swap agreement may be entered into only under the following conditions:

(1) The swap agreement would not cause the aggregate outstanding notional amounts of all of the issuing body's outstanding swap agreements on obligations payable from tax revenues to exceed 20% of the sum of all aggregate outstanding obligations of the issuing body payable from tax revenues plus obligations payable from tax revenues not yet issued but for which one or more swap agreements have been entered into by the issuing body. It provides that the Indiana Finance Authority may provide an exemption from the threshold for a local issuing body, and that the Budget Committee must review a proposed swap agreement that would cause a state issuer to exceed the threshold.

(2) The issuing body (if other than the Indiana Finance Authority) has adopted a comprehensive swap agreement policy at a public meeting that is not less restrictive than the swap agreement policy governing

the adoption of swap agreements that is in place for the Indiana Finance Authority.

(3) The swap agreement is approved by the issuing body at a public meeting and the resolution includes a thorough analysis of the risk the issuing body is assuming by entering into the swap agreement. It requires reports by the issuing body to its governing board regarding swap agreements.

**Effective Date:** July 1, 2011.

**Explanation of State Expenditures:** *Swap Agreement Limit:* The bill limits the ability of state level “issuing bodies” to utilize swap agreements in connection with its financing activities. A swap agreement is subject to these limits only if any part of the payments owed by an issuing body under the swap agreement are payable out of tax revenues or a special assessment.

The bill defines “issuing bodies” to include state agencies, commissions, and authorities, the Indiana Bond Bank, or any entity that has issued bonds payable directly or indirectly from taxes or lease rentals payable by any of these entities. The extent to which the interest cost of state level issuing bodies using swap agreements might be affected by the limits specified in the bill is unknown. The impact would depend on the swap agreements entered into by state level issuing bodies, the extent to which state level issuing bodies obtained favorable interest rates from these agreements, and the expertise of the state level issuing bodies in managing derivative instruments like swap agreements.

The bill prohibits any of these issuing bodies from utilizing a swap agreement as an investment. The bill requires an issuing body to meet the following conditions to enter into a swap agreement.

(1) The notional amounts of the outstanding swap agreements of an issuing body do not exceed 20% of the sum of: (a) all aggregate outstanding obligations of the issuing body; plus (b) obligations not yet issued but for which one or more of the swap agreements have been entered into by the issuing body. (Note: This computation excludes obligations for which no tax revenues nor special assessments were pledged as a means to repay the obligations.)

(2) The issuing body (except the Indiana Finance Authority) has adopted a comprehensive agreement policy at a public meeting with provisions governing adoption of swap agreements, that is not less restrictive than the policy of the IFA, and is submitted to the IFA for determination that it complies with the requirements of the bill.

(3) Each swap agreement is approved by resolution of the issuing body at a public meeting and the resolution includes a thorough analysis of the risk of entering into the swap agreement.

*Indiana Finance Authority (IFA):* The bill requires any state or local issuing body that enters into a swap agreement to submit to the IFA a comprehensive swap agreement policy that the issuing body has adopted for a determination by the IFA that the policy is not less restrictive than the policy of the IFA. The administrative impact due to this requirement is unknown but could potentially be minimal. The IFA’s current level of resources should be sufficient to implement this requirement.

*Background Information* - A swap agreement is a contract between a *payer* that is issuing some type of debt issue, like a local unit issuing bonds, and a *receiver*, like an investment bank. Generally, the payer is trying to exchange a floating interest rate on the principal of a debt issue for a fixed interest rate. A swap agreement does not change the principal amount of the debt issue or result in the exchange of the principal amount. It only allows the payer to make fixed rate interest payments to the receiver in exchange for the receiver making

floating rate interest payments to the payer, with the interest payments being based on the principal amount of the debt issue. Under a swap agreement, the floating interest rate would be based on some reference rate like the Prime rate or the LIBOR. The interest payments from each party would be due periodically (i.e. quarterly), at which time the floating interest rate would reset to equal the prevailing rate. There are three outcomes that can occur relative to the periodic interest payments:

- (1) If the floating rate is greater than the fixed rate at the time of payment, the investment bank pays the local unit an amount equal to the difference between the interest payment at the higher floating rate and the interest payment at the fixed rate.
- (2) If the floating rate is less than the fixed rate at the time of payment, the local unit pays the investment bank an amount equal to the difference between the interest payment at the higher fixed rate and the interest payment at the floating rate.
- (3) If the floating rate equals the fixed rate at the time of payment, no payment is exchanged between the investment bank and the local unit.

The main advantage for an entity to exchange a floating rate for a fixed rate under a swap agreement is to avoid higher interest payments under the floating rate, if interest rates are expected to increase above the fixed rate that is obtained via the swap agreement. The main disadvantage for an entity to exchange a floating rate for a fixed rate is that once in the swap agreement the entity can't take advantage of interest rates falling below the fixed rate of the swap agreement without terminating the swap agreement and paying a substantial termination fee.

### **Explanation of State Revenues:**

**Explanation of Local Expenditures:** *Swap Agreement Limit:* The bill limits the ability of local level "issuing bodies" to utilize swap agreements in connection with its financing activities. The bill defines "issuing bodies" to include a political subdivision, school corporation, hospital association, municipal corporation, special taxing district, local public improvement bond bank, or any entity that has issued bonds payable directly or indirectly from taxes or lease rentals payable by any of these entities. The bill excludes political subdivisions or other local entities participating in a program sponsored by the Indiana Bond Bank for which the Indiana Bond Bank is subject to the swap agreement limitations of the bill.

The extent to which the interest cost of local level issuing bodies might be affected by the limits specified in the bill is unknown. Comprehensive information about local units' usage of swap agreements is unavailable. The impact would depend on the swap agreements entered into by local level issuing bodies, the extent to which local level issuing bodies obtained favorable interest rates from these agreements, and the expertise of local level issuing bodies in managing derivative instruments like swap agreements.

The bill prohibits any of these issuing bodies from utilizing a swap agreement as an investment. The bill also requires an issuing body to meet the conditions specified for state level issuing bodies in (1)-(3) above under Explanation of State Expenditures.

### **Explanation of Local Revenues:**

**State Agencies Affected:** Indiana Finance Authority; State Budget Committee.

**Local Agencies Affected:** Local units.

**Information Sources:**

**Fiscal Analyst:** Jim Landers, 317-232-9869.